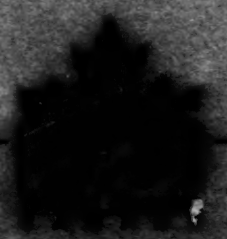
Small Business Taxes

Comparing British Columbia to Washington State



Ministry of Economic Development,
Small Business and Trade

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INTRODUCTION

This brief compares the taxes paid by small business owner-operators located in British Columbia and Washington State. To isolate the effect of taxes, both firms are assumed to have the same income before taxes, and the owner-operators draw the same salaries from their respective firms.[1]

The tax calculations used in this comparison are for an illustrative case which includes both business and personal taxes. These calculations, which are presented in Appendix 1, were reviewed by Price Waterhouse.

The comparison shows that corporate and personal taxes paid by an owner-operator of a British Columbia small business can be significantly lower than comparable taxes paid by a Washington State small business owner-operator.

This conclusion counters the widely-held perception that the corporate and personal taxes paid by small British Columbia firms are greater than those paid by small Washington State firms.

The information presented in this brief will be of interest to potential business immigrants considering a West Coast location and to British Columbia entrepreneurs assessing their competitive position.

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1 The personal income tax calculations are for an owner-operator supporting a spouse but no children.

TAX COMPARISONS

Comparing the impact of taxation in different jurisdictions using nominal tax rates or other simple tax indicators can be very misleading.

Meaningful comparisons are possible only by considering taxes paid under particular tax systems. This analysis focuses on the corporate and personal taxes paid by small owner-operated corporations in British Columbia and Washington State.

In the example chosen, the British Columbia owner-operator has net taxable corporate income of C$200,000 (the upper limit for Canadian-controlled private corporations claiming the small business deduction).

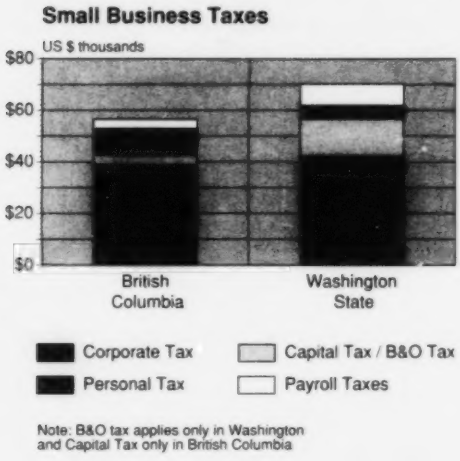
The British Columbia firm is also assumed to have taxable capital of C$1.5 million for the purposes of calculating the provincial corporation capital tax. In reality, many small businesses will have taxable capital of less than C$1 million and accordingly, will not pay any capital tax.

To calculate the Washington State business and occupation tax (a tax on gross revenues), total sales were assumed to be approximately US$2.07 million, and the firm was assumed to be a Seattle-based manufacturer, although the results would be only slightly different for a retailer in most cases.[2]

In this example, the Washington State owner-operator's total tax payments are approximately 24 per cent higher than the British Columbia owner-operator's total payments.

2 The State B and O Tax rate for a retailer is 0.471 per cent versus 0.484 per cent for manufacturing or wholesaling. A smaller B and O tax liability is partially offset by larger taxable corporate income.

The chart below summarizes the results of the comparative tax calculations.



The British Columbia owner-operator's tax advantage relative to the Washington State owner-operator is due mainly to the favorable tax treatment of small corporations in British Columbia, the impact of the business and occupation tax on Washington State firms, and low total payroll taxes in British Columbia relative to Washington State.

Detailed tax calculations are presented in Appendix 1. Appendix 2 shows the nominal tax rates in the two jurisdictions.

Corporate Income Taxes

The British Columbia owner-operator benefits from federal and provincial small business deductions applying to the first C$200,000 of income earned by a Canadian-controlled private corporation.

The Washington State corporation's federal income tax payments alone (there are no state income taxes in Washington State) are approximately nine per cent higher than combined federal and provincial corporate income taxes in British Columbia.

Washington State Business and Occupation Tax

Although Washington State businesses do not pay any state income tax, they do pay the state's business and occupation (B and O) tax which is levied on the firm's gross revenues.

Some cities (including Seattle, Bellingham, Everett, Tacoma and Bellevue, among others) impose an additional B and O tax.[3]

The adverse impact of the B and O tax on small businesses is recognized by the Washington State Department of Revenue:

> Negative features of the B and O tax are significant. Most importantly, it imposes a heavy burden on new and small businesses that may not have reached their maximum level of operating efficiency, (and) have yet to fully develop their markets ...[4]

Payroll Taxes

Combined social security taxes and unemployment insurance premiums for the Washington State owner-operator (employer plus employee portions) are more than twice the comparable payments for the British Columbia owner-operator.

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3 The B and O tax calculations in this example are for a firm located in Seattle.

4 Washington State, Department of Revenue. *Tax Reference Manual: Information on State and Local Taxes in Washington State*, January 1991, p. 71.

British Columbia owner-operators are required to purchase workers' compensation coverage at industry-specific rates.

If included in the tax calculation, the workers' compensation premiums would comprise a very small portion of total taxes paid and would not significantly alter the British Columbia owner-operator's tax advantage. For example, an owner-operator engaged in electronics manufacturing and drawing a C$60,000 salary would pay premiums of only C$240 (US $204).

Washington State owner-operators are not required to purchase workers' compensation coverage, provided they meet the eligibility criteria for the exemption. Of course, if they elect not to purchase the coverage, they are not eligible for industrial insurance fund benefits if they suffer a job-related injury or illness.

CONCLUSION

Taxes are one of many significant factors affecting the competitiveness of an enterprise. This comparison demonstrates that corporate and personal taxes paid by small business owner-operators can be much lower in British Columbia than in Washington State.

NOTES

S Corporation Status: If the Washington State owner-operator elects to be taxed as an S corporation (a corporate status under which all income is taxed at personal rates), in this example total tax paid would be slightly higher than in the regular corporate case. However, the S corporation owner-operator will not pay any further tax if dividends are paid out of the firm.

To elect S corporation status, all shareholders of the firm must be U.S. residents or citizens. In contrast, Canadian-controlled private corporations, which benefit from reduced tax rates, can be equally owned by Canadian residents and non-residents.

Capital Gains Taxes: A small business corporation owner in Canada can realize a tax free capital gain of up to C$500,000 if the business is sold. The exemption can apply if the firm is primarily engaged in active business in Canada and the shares have not been held by anyone other than the individual or related persons during the preceding two years.

In the U.S., there is no such exemption, and this capital gain would be taxed as regular personal income (although the rate on capital gains on assets held for more than one year is capped at 28 per cent, compared to the top rate on ordinary income of 31 per cent).

Mortgage Interest Deductions: U.S. homeowners have the ability to deduct all or a percentage of their mortgage interest payments for tax purposes. However, even if the Washington State owner-operator paid no personal income tax at all (an unlikely scenario given U.S. alternative minimum tax rules), the British Columbia owner-operator in this example would still have an approximately 15 per cent lower total tax payment.

Property Taxes: Property tax liabilities can differ between British Columbia and Washington State depending on the type of business activity, its location and asset structure.

Although nominal property tax rates tend to be lower in Washington State than in British Columbia, the taxable base is generally larger for Washington State firms as it includes both land and buildings and machinery and equipment (versus only land and buildings in British Columbia).

APPENDIX 1. DETAILED TAX CALCULATIONS[1]

BRITISH COLUMBIA CASE[2]	C$	US$[3]
Corporate Income Before Tax and Salary	$266,747	$226,735
Less Owner-Operator Canada Pension Plan Payment (Employer Portion)	($696)	
Less Owner-Operator Salary	($60,000)	
Less Owner-Operator Unemployment Insurance Premium (Employer Portion)[4]	($1,551)	
Net Corporate Income before Tax and Deduction of Capital Tax	$204,500	
Less Capital Tax (assuming $1,500,000 in taxable capital)	($4,500)	
Net Corporate Income for Tax Purposes	$200,000	
Federal Corporate Income Tax (28%)	$56,000	
Surtax (3% of Federal Tax)	$1,680	
Less Federal Small Business Deduction (16%)	(32,000)	
Provincial Corporate Income Tax (16%)	$32,000	
Less Provincial Small Business Deduction (6%)	($12,000)	
TOTAL CORPORATE INCOME TAX	$45,680[5]	$38,828
Personal Income (Salary)	$60,000	
Less Maximum Registered Retirement Savings Plan Contribution	($10,800)	
Taxable Personal Income	$49,200	
Federal Personal Income Tax	$10,129	
Less Basic Personal Exemption	($1,098)	
Less Married Exemption	($915)	
Less Canada Pension Plan Credit (Personal Portion)	($118)	
Less Unemployment Insurance Credit (Personal Portion)	($188)	
Basic Federal Tax (Graduated Rates)	$7,810	
Surtax (4.5% of Federal Tax)	$351	
Provincial Tax (52% of Federal Tax)	$4,061	
TOTAL PERSONAL INCOME TAX	$12,222	$10,389
SUMMARY OF TAXES PAID:		
Corporate Income Tax	$45,680	$38,828
Capital Tax	$4,500	$3,825
Total Canada Pension Plan Payment	$1,392	$1,183
Total Unemployment Insurance Premium	$2,658	$2,259
Personal Income Tax	$12,222	$10,389
TOTAL TAXES PAID	$66,452	$56,484

1 Information in this report reflects the changes made in the federal and provincial spring 1992 budgets.

2 To reflect the introduction of the capital tax, the corporation is assumed to operate on a tax year ending March 31, 1993; the owner-operator's personal income taxes are based on the 1992 calendar year.

3 Exchange rate of US$0.85/C$ used.

4 Owner-operators in many situations are not insurable and, therefore, would not be subject to premiums.

5 Net after tax corporate income is assumed to be retained within the firm to finance expansion.

WASHINGTON STATE CASE	US$
Corporate Income Before Tax and Salary	$226,735
Less Owner-Operator Social Security Tax (Employer Portion)	($3,902)
Less Owner-Operator Salary	($51,000)
Less Owner-Operator Unemployment Insurance Premium	($443)
Less Contribution to 401(k) Retirement Plan (Employer Portion)	($5,650)
Net Corporate Income before Tax and Deduction of B and O Taxes	$165,740
Less State B and O Tax (0.484% for Manufacturer)	($10,027)
Less Seattle B and O Tax (0.215% for Manufacturer)[1]	($4,454)
Total B and O Taxes	($14,482)
Net Corporate Income for Tax Purposes	$151,259
TOTAL CORPORATE INCOME TAX	$42,241[2]
Personal Income (Salary)	$51,000
Less Standard Deduction	($6,000)
Less Personal Exemption	($4,600)
Less Contribution to 401(k) Retirement Plan (Personal Portion)	($5,650)
Taxable Personal Income	$34,750
TOTAL PERSONAL INCOME TAX	$5,213
SUMMARY OF TAXES PAID:	
Corporate Income Tax	$42,241
B and O Taxes	$14,482
Total Social Security Tax	$7,803
Total Unemployment Insurance Premium	$443
Personal Income Tax	$5,213
TOTAL TAXES PAID	$70,182

1 For the purposes of calculating the B and O tax, revenues of US $2,071,750 were assumed (an eight per cent margin on net corporate income before tax and deduction of B and O taxes). To determine city B and O taxes, the Seattle B and O tax rate was used. The rate for Bellingham is 0.170%, however, the benefit of a lower B and O tax rate for a Bellingham firm would be partially offset by higher corporate income tax.

2 Net after tax corporate income is assumed to be retained within the firm to finance expansion.

APPENDIX 2. COMPARATIVE NOMINAL PERCENTAGE TAX RATES (1992)

	British Columbia	% Rate	Washington State	% Rate
Corporate Income Taxes				
(% of taxable income)				
Federal	C$0 to $200,000	12.84[a]	US$0 to $50,000	15
			$50,000 to $75,000	25
			$75,000 to $100,000	34
			$100,000 to $335,000	39[b]
Provincial/State	C$0 to $200,000	10.0[a]		N/A
Business and Occupation Tax				
(% of gross revenue)				
State		N/A		0.484[c]
City (Seattle)		N/A		0.215[c]
Capital Tax				
(% of taxable capital)		0.3[d]		N/A
Base Minimum	C$1,000,000			
Personal Income Taxes				
Federal	C$0 to $29,590	17	US$0 to $35,800	15[e]
(% of taxable income)	$29,590 to $59,180	26	$35,800 to $86,500	28
	over $59,180	29	over $86,500	31
Individual Surtax				
(% of federal tax)		4.5		N/A
Provincial				
(% of federal tax)		52		N/A
Payroll Taxes[f]				
(% of gross pay)				
Social Insurance				
		4.8		15.3
Base Maximum	C$32,200[g]		US$55,500	
Unemployment Insurance				
Federal		7.2[h]		0.8
Base Maximum	C$36,920		US$7,000	
Provincial/State		N/A		2.2
Base Maximum	N/A		US$17,600	

(a) Rates are for a Canadian-controlled private corporation (CCPC). On the portion of income above $200,000, a CCPC engaged in manufacturing would pay a federal rate of 23.84% and a provincial rate of 16.0%.

(b) The effects of the lower graduated rates are phased out in this taxable income range. Above US$335,000 the rate is 34 per cent.

(c) Rate for manufacturers.

(d) The capital tax is phased in for capital between C$1 million and C$1.25 million; above C$1.25 million, the capital tax is applied to the entire amount of taxable capital at a rate of 0.3%.

(e) Graduated rates for married individual filing with spouse.

(f) Payroll tax rates are combined employer/employee contributions.

(g) First C$3,200 exempt.

(h) Owner-operators are in many cases not insurable and, therefore, would not be subject to premiums.

This document provides general business information only. Individuals and companies should seek appropriate professional advice in making specific business decisions.